

FINANCIAL STATEMENTS – STATUTORY BASIS

Physicians Insurance A Mutual Company
Years Ended December 31, 2019 and 2018
With Report of Independent Auditors

Ernst & Young LLP



Physicians Insurance A Mutual Company

Financial Statements – Statutory Basis

Years Ended December 31, 2019 and 2018

Contents

Report of Independent Auditors.....1

Financial Statements – Statutory Basis

Balance Sheets – Statutory Basis3

Statements of Income – Statutory Basis4

Statements of Changes in Policyholders’ Surplus – Statutory Basis.....5

Statements of Cash Flows – Statutory Basis.....6

Notes to Financial Statements – Statutory Basis7



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Report of Independent Auditors

The Board of Directors
Physicians Insurance A Mutual Company

We have audited the accompanying statutory-basis financial statements of Physicians Insurance A Mutual Company (the Company), which comprise the balance sheets as of December 31, 2019 and 2018, and the related statements of income, changes in policyholders' surplus and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with accounting practices prescribed or permitted by the Washington State Office of the Insurance Commissioner. Management also is responsible for the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

As described in Note 1 to the statutory-basis financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Washington State Office of the Insurance Commissioner, which is a basis of accounting other than U.S. generally accepted accounting principles. The effects on the financial statements of the variances between these statutory accounting practices and U.S. generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the matter described in the Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles paragraph, the statutory-basis financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of the Company at December 31, 2019 and 2018, or the results of its operations or its cash flows for the years then ended.

Opinion on Statutory-Basis of Accounting

In our opinion, the statutory-basis financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2019 and 2018, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note 1.

Ernst + Young LLP

May 26, 2020

Physicians Insurance A Mutual Company

Balance Sheets – Statutory Basis

	December 31	
	2019	2018
Admitted assets		
Cash and investments:		
Bonds, at amortized cost (fair value of \$402,572,963 and \$378,870,814 at December 31, 2019 and 2018, respectively)	\$ 385,033,579	\$ 379,519,583
Common stocks, at fair value (cost of \$49,596,886 and \$47,010,532 at December 31, 2019 and 2018, respectively)	94,845,688	72,100,957
Cash of \$18,453,562 and \$11,869,278, and short-term investments of \$1,380,979 and \$4,048,742 at December 31, 2019 and 2018, respectively	19,834,541	15,918,020
Investments in subsidiaries and affiliates	5,422,704	15,442,062
Total cash and investments	505,136,512	482,980,622
Uncollected premiums and agents' balances in the course of collection	19,495,016	13,047,471
Reinsurance recoverables on paid losses	3,513,818	134,678
Other amounts receivable under reinsurance contracts	2,824,542	141,810
Federal income taxes recoverable	668,738	–
Net deferred tax assets	–	1,152,726
EDP equipment and software	90,072	162,452
Accrued interest and dividends	3,825,590	3,277,913
Due from affiliates	892,619	705,356
Other assets	449,457	269,051
Total admitted assets	\$ 536,896,364	\$ 501,872,079
Liabilities and policyholders' surplus		
Liabilities:		
Reserves for losses	\$ 149,106,039	\$ 140,601,499
Reserves for loss adjustment expenses	54,716,392	50,362,157
Reinsurance payable on paid losses and loss adjustment expenses	281,168	94,351
Unearned premiums	35,472,315	29,376,872
Premium deposits	11,853,754	10,316,223
Other expenses	4,402,684	5,670,613
Retroactive reinsurance reserves assumed	3,564,856	7,271,768
Taxes, licenses, and fees	332,835	135,069
Provision for reinsurance	101,285	89,961
Ceded reinsurance premium payable to reinsurers	4,366,112	4,173,247
Federal income taxes payable	–	855,967
Net deferred tax liability	2,532,977	–
Total liabilities	266,730,417	248,947,727
Policyholders' surplus	270,165,947	252,924,352
Total liabilities and policyholders' surplus	\$ 536,896,364	\$ 501,872,079

See accompanying notes.

Physicians Insurance A Mutual Company

Statements of Income – Statutory Basis

	Year Ended December 31	
	2019	2018
Revenues:		
Premiums earned	\$ 122,920,161	\$ 107,626,899
Less ceded reinsurance premiums	(18,538,837)	(14,183,963)
Net premiums earned	104,381,324	93,442,936
Losses and expenses:		
Net losses incurred	52,371,683	49,570,742
Net loss adjustment expenses incurred	39,974,965	26,151,294
Other underwriting expenses incurred	22,536,501	19,367,402
Total underwriting deductions	114,883,149	95,089,438
Net underwriting loss	(10,501,825)	(1,646,502)
Net investment income earned	18,406,422	15,070,505
Net realized capital gains, less taxes of \$306,071 and \$401,094 at December 31, 2019 and 2018, respectively	1,151,409	1,508,879
Net investment gain	19,557,831	16,579,384
Net (loss) gain from agents' or premium balances (charged off) recovered	(4,167)	3,658
Finance and service charges not included in premiums	271,806	262,345
Other income, net	2,000,385	3,001,356
Total other income	2,268,024	3,267,359
Income before dividends to policyholders and before federal income taxes	11,324,030	18,200,241
Dividends to policyholders	5,002,244	5,002,475
Income after dividends to policyholders and before federal income taxes	6,321,786	13,197,766
Federal income taxes incurred	72,849	1,668,815
Net income	\$ 6,248,937	\$ 11,528,951

See accompanying notes.

Physicians Insurance A Mutual Company

Statements of Changes in Policyholders' Surplus – Statutory Basis

	Year Ended December 31	
	2019	2018
Policyholders' surplus, at beginning of year	\$ 252,924,352	\$ 250,158,164
Net income	6,248,937	11,528,951
Change in unauthorized reinsurance	(11,324)	1,048,212
Change in nonadmitted assets	788,435	3,624,665
Change in net unrealized capital gains less capital gains tax on investments	9,705,103	(11,007,825)
Change in net deferred income taxes	510,444	(2,427,815)
Policyholders' surplus, at end of year	<u>\$ 270,165,947</u>	<u>\$ 252,924,352</u>

See accompanying notes.

Physicians Insurance A Mutual Company

Statements of Cash Flows – Statutory Basis

	Year Ended December 31	
	2019	2018
Operating activities		
Premiums collected, net of reinsurance	\$ 104,744,855	\$ 89,876,566
Net investment income	19,756,807	17,413,484
Miscellaneous income	268,028	267,358
Total	124,769,690	107,557,408
Benefits and loss-related payments	47,239,630	38,965,930
Expenses paid	60,992,002	48,236,255
Dividends paid	5,002,244	5,002,475
Federal income taxes paid	1,903,625	1,703,362
Total	115,137,501	93,908,022
Net cash provided by operating activities	9,632,189	13,649,386
Investing activities		
Proceeds from investments sold, matured, or repaid:		
Bonds	60,538,650	68,827,376
Common stocks	8,839,853	1,955,607
Total investment proceeds	69,378,503	70,782,983
Cost of investments acquired:		
Bonds	67,828,626	72,258,713
Common stocks	2,586,353	3,183,421
Other invested assets	2,600,000	1,500,000
Total investments acquired	73,014,979	76,942,134
Net cash used in investing activities	(3,636,476)	(6,159,151)
Financing and miscellaneous activities		
Other cash applied	(2,079,192)	(873,458)
Net change in cash and short-term investments	3,916,521	6,616,777
Cash and short-term investments at beginning of year	15,918,020	9,301,243
Cash and short-term investments at end of year	\$ 19,834,541	\$ 15,918,020

See accompanying notes.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis

December 31, 2019

1. Description of the Company and Significant Accounting Policies

Physicians Insurance A Mutual Company (the Company) provides comprehensive professional liability insurance to physicians and hospitals practicing primarily in the states of Washington, Oregon, Idaho, Alaska, and Wyoming. The Company writes claims-made professional liability policies, provider excess, and medical stop-loss policies that protect medical provider organizations and self-insured employers from catastrophic losses.

The Company has one insurance subsidiary, Western Professional Insurance Company (WPIC), which has been in runoff since 2005 and the remaining liabilities are ceded to the Company. The Company has an insurance agency subsidiary that sells physicians products provided by other insurance carriers, such as business owners policies, employment practices liability, long-term care, disability, life, and health. The Company also has subsidiaries that provide management and other services to risk retention groups.

The Company, domiciled in Washington state, prepares its statutory-basis financial statements in conformity with the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual*, which has been adopted by the state of Washington, subject to any deviations prescribed or permitted by the Washington State Office of the Insurance Commissioner (Department). The Department has no significant accounting practices that differ from those found in NAIC statutory accounting principles.

NAIC accounting practices differ in certain respects from U.S. generally accepted accounting principles (GAAP). Significant differences are as follows:

- Acquisition expenses relating to the issuance of new policies are charged to expense as incurred. Under GAAP, certain policy acquisition costs to the extent recoverable would be deferred and amortized over the effective period of the related insurance policies.
- The Company's insurance subsidiary (WPIC) is recorded using the statutory net equity method, while investments in the Company's other subsidiaries are nonadmitted. The change in the subsidiaries' equity is included in the change in net unrealized capital gains or losses. Under GAAP, such investments would be consolidated with the accounts and operations of the Company.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

1. Description of the Company and Significant Accounting Policies (continued)

- Certain assets designated as “nonadmitted” assets are excluded from the balance sheets, and the changes in such assets are credited or charged directly to unassigned surplus. These assets primarily consist of unaudited subsidiaries, the nonadmitted portion of deferred taxes, and property and equipment. Under GAAP, such assets are included on the balance sheets to the extent that those assets are not impaired.
- Investments are carried at values prescribed by the NAIC. Generally, bonds are stated at amortized cost (unless the NAIC requires fair value), and equity securities of nonaffiliates are stated at fair value with changes in fair value recognized directly to policyholders’ surplus net of related deferred taxes. Under GAAP, bonds would be designated at purchase as held to maturity, trading, or available for sale. Held-to-maturity fixed maturity investments would be reported at amortized cost, and the remaining fixed maturity investments would be reported at fair value, with unrealized holding gains and losses reported in operations for those designated as trading and as a separate component of other comprehensive income, net of the related deferred taxes, for those designated as available for sale. Equity securities would be reported at fair value with changes in fair value recognized in the Company’s results of operations within net realized gains and losses on financial instruments.
- The Company’s investments in its insurance subsidiaries are included in affiliated common stocks and are carried at their underlying statutory equity. Changes in the carrying value of subsidiaries are recorded directly to policyholders’ surplus. Under GAAP, such subsidiaries would be consolidated with the accounts and operations of the Company.
- Deferred tax assets and liabilities are determined in a manner similar to GAAP; however, additional criteria are then applied to those assets that may require certain amounts to be nonadmitted. The change in net deferred tax assets is recorded as a change in policyholders’ surplus. Under GAAP, a deferred tax asset is recorded for the amount of gross deferred tax assets expected to be realized in future years, and a valuation allowance is established for deferred tax assets not realizable.
- Ceded reinsurance recoverables on unpaid losses and loss adjustment expenses are recorded as a reduction to the reserves for losses and loss adjustment expenses. Additionally, the unexpired portion of ceded reinsurance premiums is recorded as a reduction of unearned premiums. Under GAAP, ceded reinsurance recoverables and ceded reinsurance premiums are reported as assets.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

1. Description of the Company and Significant Accounting Policies (continued)

- A liability is provided for uncollateralized reinsurance balances of reinsurers not authorized to do business by the Department, and changes to those amounts are credited or charged directly to policyholders' surplus. Under GAAP, an allowance for amounts deemed uncollectible would be established through a charge to earnings.
- Commissions allowed by reinsurers on business ceded are reported as income when incurred to the extent the amount does not exceed actual acquisition costs rather than being deferred and amortized with deferred policy acquisition costs, as would be required under GAAP.
- The statements of cash flows differ in certain respects from the presentation required by GAAP. Cash and short-term investments in the statutory-basis statements of cash flows represent cash balances and investments with initial maturities of one year or less. If in the aggregate the Company has a negative cash balance, it is reported as a negative asset and not a liability. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with initial maturities of three months or less. Short-term investments are reported separately, and negative cash balances are also reported separately as liabilities.
- Realized gains or losses are recorded net of tax on the statements of income. Under GAAP, the tax associated with realized gains or losses is recorded as an income tax expense or benefit.
- Dividends are recorded as an expense on the statements of income when declared. Under GAAP, policyholder dividends are accrued over the term of the related policies.

The effects of the foregoing variances from GAAP on the Company's statutory-basis financial statements have not been determined, but are presumed to be material.

Other significant accounting practices are as follows:

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

1. Description of the Company and Significant Accounting Policies (continued)

Cash and Short-Term Investments

Cash consists of cash in the bank or on hand and available for current use. The Company considers all liquid instruments with a maturity of one year or less at the time of purchase to be short-term investments. The carrying amount of cash and short-term investments approximates fair value because of the short-term maturity of those instruments.

Investments

Bonds are reported at statement value as prescribed by the NAIC. Bonds that are investment grade (NAIC designation 1 or 2) are stated at cost or amortized cost. All other bonds (NAIC designations 3 to 6) are stated at the lower of amortized cost or fair value. Discount or premium on bonds is amortized using the effective-yield method.

Mortgage-backed securities are adjusted using the prospective method. Prepayment assumptions for single and multiclass mortgage-backed and asset-backed securities are obtained from independent pricing sources.

Common stocks are stated at fair value, and the related net unrealized capital gains (losses) are reported in policyholders' surplus along with any adjustment for federal income taxes.

Surplus notes with a designation of NAIC 1 or NAIC 2 are reported at amortized cost. All other surplus notes are reported at the lesser of amortized cost or fair value according to Statement of Statutory Accounting Principles (SSAP) No. 41R.

The Company uses the first-in, first-out method in determining gains and losses from the sale of investments. The Company monitors investments for other-than-temporary impairment. In determining whether the losses are temporary or other than temporary, the Company considers (1) the length of time and extent to which the fair value has been less than cost or carrying value, (2) the financial strength of the issuer, and (3) its intent to sell the security or the Company's ability to hold the security long enough to recover in value.

Interest and dividend income is recorded on the accrual basis.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

1. Description of the Company and Significant Accounting Policies (continued)

Premiums

Premiums are earned over the terms of the related policies. The Company anticipates investment income as a factor in premium deficiency calculations. Unearned premium reserves are established to cover the unexpired portion of premiums written. Such reserves are computed by pro rata methods for direct and assumed business. Premiums related to coverages for doctors who retire, die, or are disabled are deferred as unearned premiums and are recognized as earned when an insured retires, dies, becomes disabled, or terminates coverage, whichever event occurs first; unearned premiums of \$9,200,000 and \$12,400,000 at December 31, 2019 and 2018, respectively, are for this coverage, which is referred to as DD&R coverage.

In determining unearned premiums related to DD&R, the Company includes an estimate for unexercised extended reporting endorsements utilizing actuarial models, including assumptions for the time value of money, loss trends, and the degree by which the loss experience of DD&R policies is likely to be below that implied by the Company's historical claims-made experience. Although the Company considers its experience and industry data in determining unearned premium related to DD&R, assumptions and projections of future events are necessary and unearned premiums may differ materially from amounts projected in the near term.

Premium deposits represent premium payments received from policyholders of the Company for policies not in effect until the ensuing calendar year.

Reserves for Losses and Loss Adjustment Expenses

The reserves for losses and loss adjustment expenses are established on the basis of reported losses (case-basis method). Provision is also made for claims incurred but not reported and related loss adjustment expenses. These amounts are based on the estimates of management and are subject to risks and uncertainties. Changes in estimates of losses and loss adjustment expenses are included in income for the period in which the estimates are changed. The Company does not discount loss and loss adjustment expense reserves. The method of making such estimates and establishing the resulting reserves is based on actuarial assumptions of future contingencies and the applicability of other data sources such as recent settlements, claim frequency, and other economic and social factors. A provision for inflation in the calculation of estimated future claims costs is implicit in the calculation because reliance is placed both on actual historical data that reflects past inflation

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

1. Description of the Company and Significant Accounting Policies (continued)

and on other factors that are considered to be appropriate modifiers of past experience. Although the Company considers its experience and industry data in determining such reserves, assumptions and projections of future events are necessary, and the ultimate amounts may differ materially from the amounts recorded or disclosed.

Reinsurance

The Company protects itself from excessive losses by reinsuring certain levels of risk in various areas of exposure with reinsurers. The Company also assumes risk from other insurance entities. Reinsurance coverage is provided on both a quota share and excess of loss basis. Prospective ceded and assumed reinsurance premiums, losses, and loss adjustment expenses are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Certain ceded and assumed reinsurance premiums include adjustments based on losses incurred, subject to certain limits, and are recorded on a best-estimate basis.

Ceded and assumed reinsurance premiums payable or receivable represent actual reinsurance costs in excess of deposits made and return premiums from prior years.

Retrospective reinsurance contracts are recorded as a liability and evaluated periodically for adequacy of the reserves. Gains and losses from the contracts are recorded in other income on the income statement.

Income Taxes and Deferred Taxes

The Company accounts for income taxes under the liability method, which requires the recognition of deferred taxes and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the differences between financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are limited to those that will more likely than not (defined as a likelihood of more than 50%) generate a tax benefit, and a valuation allowance is established if necessary to reduce the deferred tax asset to an amount that is more likely than not to be realized. No valuation allowance has been recorded as of December 31, 2019 or 2018.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

1. Description of the Company and Significant Accounting Policies (continued)

Deferred income taxes are further subject to limitations as to the amount of deferred income tax assets that may be reported as “admitted assets.” Admitted deferred tax assets are limited to (1) the amount of federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse within the Internal Revenue Service loss carryback provisions; (2) the lesser of the remaining gross deferred tax assets expected to be realized within one year to three years of the balance sheet date or 10% to 15% of capital and surplus, excluding surplus arising from any net deferred tax assets, electronic data processing (EDP) equipment, operating software, and net positive goodwill; and (3) the amount of remaining gross deferred tax assets that can be offset against existing gross deferred tax liabilities. The Company considers character (capital or ordinary) in admitting deferred tax assets. Deferred income taxes do not include amounts for state income taxes.

Use of Estimates

The preparation of financial statements in conformity with accounting practices prescribed or permitted by the Department requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the statutory-basis financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant accounts subject to management estimates are reserves for losses and loss adjustment expenses, reinsurance recoverables on unpaid losses and loss adjustment expenses, unearned premium reserves, other-than-temporary impairment of invested assets, and the admitted portion of deferred tax assets.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

2. Investments

The cost or amortized cost, gross unrealized gains or losses, and fair value of investments are as follows:

	Book/ Adjusted Carrying Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2019				
U.S. treasury securities and obligations of U.S. government corporations and agencies	\$ 36,729,244	\$ 2,198,086	\$ (27,032)	\$ 38,900,298
Obligations of states and political subdivisions	105,319,707	4,700,616	(183,544)	109,836,779
Corporate securities	128,945,762	8,238,078	(94,072)	137,089,768
Mortgage-backed/ asset-backed securities	114,038,866	2,920,373	(213,121)	116,746,118
Total bonds	<u>385,033,579</u>	<u>18,057,153</u>	<u>(517,769)</u>	<u>402,572,963</u>
Common stocks	49,596,886	45,290,492	(41,690)	94,845,688
Total bonds and common stocks	<u>\$ 434,630,465</u>	<u>\$ 63,347,645</u>	<u>\$ (559,459)</u>	<u>\$ 497,418,651</u>

	Book/ Adjusted Carrying Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2018				
U.S. treasury securities and obligations of U.S. government corporations and agencies	\$ 29,346,169	\$ 584,939	\$ (423,877)	\$ 29,507,231
Obligations of states and political subdivisions	108,653,557	2,117,021	(763,721)	110,006,857
Corporate securities	123,229,943	1,575,837	(2,649,171)	122,156,609
Mortgage-backed/ asset-backed securities	118,289,914	619,970	(1,709,767)	117,200,117
Total bonds	<u>379,519,583</u>	<u>4,897,767</u>	<u>(5,546,536)</u>	<u>378,870,814</u>
Common stocks	47,010,532	25,834,924	(744,499)	72,100,957
Total bonds and common stocks	<u>\$ 426,530,115</u>	<u>\$ 30,732,691</u>	<u>\$ (6,291,035)</u>	<u>\$ 450,971,771</u>

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

2. Investments (continued)

WPIC, and other affiliates, had a carrying value of \$5,422,704 and \$15,442,062 at December 31, 2019 and 2018, respectively. Certain other subsidiaries and affiliates with a total carrying value of \$1,030,337 and \$2,172,560 at December 31, 2019 and 2018, respectively, are nonadmitted. Equity in earnings (losses) of subsidiaries is included in the change in unrealized capital gains (losses) and was \$(6,223,534) and \$(4,674,659) for the years ended December 31, 2019 and 2018, respectively.

The cost or amortized cost and fair value of bonds by contractual maturity at December 31, 2019, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Cost or Amortized Cost	Fair Value
Due in one year or less	\$ 17,461,516	\$ 17,648,320
Due between one year and five years	89,942,923	92,945,953
Due between five years and ten years	102,727,181	107,994,646
Due after ten years	60,863,093	67,237,926
Mortgage-backed/asset-backed securities	114,038,866	116,746,118
	<u>\$ 385,033,579</u>	<u>\$ 402,572,963</u>

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

2. Investments (continued)

Provided below is a summary of securities that were in an unrealized loss position as of December 31, 2019 and 2018. Management does not believe any individual unrealized loss as of December 31, 2019 or 2018, represents an other-than-temporary impairment, as the quantitative and qualitative criteria used by management to determine other-than-temporary impairment have not been met. The Company does not have the intent to sell and has the intent and ability, at the reporting date, to hold these investments until maturity or until fair value recovers above cost or amortized cost. In 2019 and 2018, there were no realized losses due to other-than-temporary impairments in value.

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<i>(In Thousands)</i>						
December 31, 2019						
U.S. treasury and obligations of U.S. government	\$ 3,496	\$ 27	\$ –	\$ –	\$ 3,496	\$ 27
Obligations of states and political subdivisions	7,319	183	–	–	7,319	183
Corporate securities	3,200	70	482	24	3,682	94
Mortgage-backed/asset-backed securities	8,103	55	7,637	158	15,740	213
Common stocks	1,194	3	621	39	1,815	42
Temporarily impaired securities	<u>\$ 23,312</u>	<u>\$ 338</u>	<u>\$ 8,740</u>	<u>\$ 221</u>	<u>\$ 32,052</u>	<u>\$ 559</u>

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<i>(In Thousands)</i>						
December 31, 2018						
U.S. treasury and obligations of U.S. government	\$ 5,528	\$ 19	\$ 6,600	\$ 405	\$ 12,128	\$ 424
Obligations of states and political subdivisions	17,449	186	18,080	578	35,529	764
Corporate securities	62,511	1,777	14,669	872	77,180	2,649
Mortgage-backed/asset-backed securities	39,045	490	40,759	1,220	79,804	1,710
Common stocks	10,168	686	268	58	10,436	744
Temporarily impaired securities	<u>\$ 134,701</u>	<u>\$ 3,158</u>	<u>\$ 80,376</u>	<u>\$ 3,133</u>	<u>\$ 215,077</u>	<u>\$ 6,291</u>

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

2. Investments (continued)

Proceeds from sales of bonds during 2019 and 2018 were \$31,383,393 and \$39,599,817, respectively. Gross gains of \$175,116 and \$178,717 and gross losses of \$48,623 and \$137,515 were realized on those sales during 2019 and 2018, respectively. Gross gains of \$0 and \$5,288 and gross losses of \$8,867 and \$92,124 were realized from other transactions during 2019 and 2018, respectively.

The number of CUSIPs and aggregate amount of investment income generated as a result of a prepayment penalty and/or acceleration fees during 2019 and 2018 were 2 and \$29,709, and 4 and \$63,943, respectively.

Proceeds from sales of common stock during 2019 and 2018 were \$5,266,666 and \$0, respectively. Gross gains of \$1,339,853 and \$1,955,607 were realized on equity securities during 2019 and 2018, respectively. No gross losses were realized during 2019 or 2018.

The Company has the following restricted securities:

Certain bonds were on deposit with the Washington and Nevada Office of the Insurance Commissioner for the protection of policyholders. The amortized cost of these securities at December 31, 2019 and 2018, was \$2,730,236 and \$2,506,387, respectively.

Net investment income is summarized as follows:

	<u>2019</u>	<u>2018</u>
Interest and dividend income	\$ 14,208,278	\$ 13,900,593
Dividends from affiliates	5,193,301	2,154,000
Less investment expenses	(995,157)	(984,088)
	<u>\$ 18,406,422</u>	<u>\$ 15,070,505</u>

No amounts of investment income due and accrued have been excluded from surplus.

Credit risk is managed by entering into transactions with creditworthy counterparties and obtaining collateral where appropriate and customary. Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of corporate debt securities. As the portfolio is well diversified and issuers of securities are dispersed throughout many industries and geographies, the concentrations of credit risk are limited.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

3. Fair Value of Financial Instruments

The following methods and assumptions were used by the Company in estimating the fair value of financial instruments in the accompanying financial statements and notes:

Cash and short-term investments: The carrying amounts reported on the accompanying balance sheets for these financial instruments approximate fair value.

Investment securities: Fair values for investment securities are primarily based on prices received from a third-party pricing service that uses observable market information in determining the fair value. Fair values for private placement securities are based on unit prices published by the Securities Valuation Office (SVO), or in the absence of SVO published unit prices, observable market inputs other than quoted market prices. See Note 2 for additional fair value information.

For all other financial instruments (payables and receivables), carrying value approximates fair value.

Financial assets and liabilities carried at fair value have been classified, for disclosure purposes, based on a fair value hierarchy. The three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies, is as follows:

Level 1 – Valuations based on quoted prices for identical assets and liabilities in active markets.

Level 2 – Valuations based on observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.

Level 3 – Valuations based on unobservable inputs reflecting the Company's own assumptions, consistent with reasonably available assumptions made by other market participants. These valuations require significant judgment.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

3. Fair Value of Financial Instruments (continued)

The aggregate fair values of all financial instruments and their level within the fair value hierarchy at December 31 are as follows:

Type of Financial Instrument	Aggregate Fair Value	Admitted Assets	Level 1	Level 2	Level 3	Net Asset Value	Not Practical (Carrying Value)
2019							
Common stocks*	\$ 94,845,688	\$ 94,845,688	\$ 94,845,688	\$ –	\$ –	\$ –	\$ –
Bonds	402,572,963	385,033,579	32,335,884	370,237,079	–	–	–
Short-term investments*	1,380,979	1,380,979	1,380,979	–	–	–	–
Surplus notes or debentures*	2,190,000	2,190,000	–	–	2,190,000	–	–
2018							
Common stocks*	\$ 72,100,957	\$ 72,100,957	\$ 72,100,957	\$ –	\$ –	\$ –	\$ –
Bonds	378,870,814	379,519,583	24,250,606	354,620,208	–	–	–
Short-term investments*	4,048,742	4,048,742	4,048,742	–	–	–	–
Surplus notes or debentures*	1,169,600	1,169,600	–	–	1,169,600	–	–

*Measured at fair value on a recurring basis.

Fair Value Measurements in Level 3 of the Fair Value Hierarchy

2019

Description	Beginning Balance at January 1, 2019	Transfers Into Level 3	Transfers Out of Level 3	Total Gains (Losses) Included in Net Income	Total Gains (Losses) Included in Surplus	Purchases	Issuances	Sales	Settlements	Ending Balance at December 31, 2019
a) Assets:										
Surplus debentures – affiliate	\$1,169,600	\$ –	\$ –	\$ –	\$ 20,400	\$1,000,000	\$ –	\$ –	\$ –	\$ 2,190,000
Total assets	\$1,169,600	\$ –	\$ –	\$ –	\$ 20,400	\$1,000,000	\$ –	\$ –	\$ –	\$ 2,190,000

2018

Description	Beginning Balance at January 1, 2018	Transfers Into Level 3	Transfers Out of Level 3	Total Gains (Losses) Included in Net Income	Total Gains (Losses) Included in Surplus	Purchases	Issuances	Sales	Settlements	Ending Balance at December 31, 2018
a) Assets:										
Surplus debentures – affiliate	\$1,287,400	\$ –	\$ –	\$ –	\$ (117,800)	\$ –	\$ –	\$ –	\$ –	\$ 1,169,600
Total assets	\$1,287,400	\$ –	\$ –	\$ –	\$ (117,800)	\$ –	\$ –	\$ –	\$ –	\$ 1,169,600

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

3. Fair Value of Financial Instruments (continued)

The surplus note is included in investments in subsidiaries and affiliates on the balance sheet and valued based on the income approach per SSAP 100, *Fair Value*. The income approach uses a valuation technique to convert the future amounts (interest cash flows for the surplus note) to a single present value amount (discounted). The annual coupon rate of 1.25%, maturity date of May 1, 2035, and the annual required return of 3.57% were used to calculate the value. The amortized cost of the surplus note is \$3,000,000.

4. Reinsurance

Under reinsurance agreements, the Company cedes various amounts of risk to other insurance companies. The professional liability reinsurance agreements that became effective July 1, 2016, provide for an initial retention by the Company of the first \$2,000,000 of loss per event, with coverage of the excess up to \$35,000,000. Prior to July 1, 2016, the Company retained the first \$3,000,000 with respect to individual incidents. The stop-loss liability insurance coverage business was reinsured in 2019 and 2018 through a 50% quota share reinsurance arrangement. In 2019 and 2018, cyber liability coverage was reinsured at 100%. D&O coverage, which was reinsured 100% in 2014, was not reinsured in 2015. It has been reinsured since July 1, 2016, under the same reinsurance agreements as the Company's professional liability agreements.

	Direct Business	Reinsurance Assumed Affiliated	Reinsurance Assumed Nonaffiliated	Reinsurance Ceded Nonaffiliated	Net Reported
Year ended December 31, 2019					
Premiums written	\$ 108,243,113	\$ 19,615,127	\$ 4,148,507	\$ (21,529,980)	\$ 110,476,767
Premiums earned	102,545,959	16,787,855	3,586,347	(18,538,837)	104,381,324
Losses (recoveries)	55,686,175	8,617,135	171,478	(12,103,105)	52,371,683
Loss adjustment expenses (recoveries)	35,269,249	3,898,906	1,356,670	(549,860)	39,974,965
Underwriting expenses	17,314,959	6,639,442	733,794	(2,151,694)	22,536,501
Year ended December 31, 2018					
Premiums written	\$ 94,442,985	\$ 11,311,735	\$ 3,330,085	\$ (14,827,895)	\$ 94,256,910
Premiums earned	98,417,978	6,156,819	3,052,102	(14,183,963)	93,442,936
Losses (recoveries)	55,697,605	2,907,076	1,596,623	(10,630,562)	49,570,742
Loss adjustment expenses (recoveries)	24,794,493	1,741,586	82,043	(466,828)	26,151,294
Underwriting expenses	16,802,182	3,112,920	1,128,287	(1,675,987)	19,367,402

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

4. Reinsurance (continued)

Reinsurance recoverables from unauthorized reinsurers in excess of applicable letters of credit are considered nonadmitted assets. The amounts of nonadmitted reinsurance recoverables as of December 31, 2019 and 2018, were \$101,285 and \$89,961, respectively.

A contingent liability exists with respect to reinsured losses that would become an actual liability of the Company in the event that the reinsurers are unable to meet the obligations assumed by them under the reinsurance agreements as the reinsurance does not relieve the Company from the responsibility to the policyholders. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from activities or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies.

There were no unsecured reinsurance recoverables in excess of 3% of surplus as of December 31, 2019 or 2018. There would be no commissions due if reinsurance were canceled.

Contingent commissions of \$49,376 and \$756,830 were accrued as of December 31, 2019 and 2018, respectively.

Assumed retroactive reinsurance as of December 31, 2019 and 2018, is \$3,564,856 and \$7,271,768, respectively. In January 2017, the Company received approximately \$12 million as part of a loss portfolio transfer agreement entered into in December 2016. The cash received increased financing and miscellaneous activities cash flows. Loss and loss adjustment expenses of \$4,519,174 and \$2,812,262 were paid as of December 31, 2019 and 2018, respectively. In 2019 and 2018, favorable development of \$2,000,000 and \$3,000,000, respectively, in reserves related to retroactive reinsurance in assumed business was recognized in other income.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

5. Reserves for Losses and Loss Adjustment Expenses

Activity in the reserves for losses and loss adjustment expenses is summarized as follows:

	2019	2018
Balance – January 1, net of reinsurance recoverables of \$22,791,438 and \$36,545,090	\$ 190,963,656	\$ 188,782,732
Incurred related to:		
Current year	98,309,792	93,150,568
Prior years	(5,963,144)	(17,428,532)
Total incurred	92,346,648	75,722,036
Paid related to:		
Current year	9,652,015	9,572,117
Prior years	69,835,858	63,968,995
Total paid	79,487,873	73,541,112
Balance – December 31, net of reinsurance recoverables of \$22,709,122 and \$22,791,438	\$ 203,822,431	\$ 190,963,656

As a result of changes in estimates of insured events in prior years, the provision for losses and loss adjustment expenses decreased by \$5,963,144 and \$17,428,532 in 2019 and 2018, respectively, due to lower than anticipated losses on professional liability claims. Positive reserve development came principally from accident years 2016 and 2018, which was partially offset by reserve strengthening for accident years 2015 and 2017.

The Company has purchased annuities from life insurers under which the claimants are payees. The Company has obtained a release of liability from the claimants and, therefore, has no contingent liability if these annuities fail to perform under their terms.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

6. Federal Income Taxes

The Company's federal income tax return is consolidated with its subsidiaries:

- Western Professional Insurance Company
- Association Insurance Services, Inc.
- PHYSIS Corporation
- Washington State Physicians Insurance Association, Inc.
- EMPAC Managers, Inc.

WPIC withdrew from the agreement effective December 31, 2019, which will be the final year it is consolidated with the Company.

The Company has a written agreement that sets forth the manner in which the total combined federal income tax is allocated to each entity that is party to the consolidation. Allocation is based on separate return calculations with credit for losses/credits where losses/credits result in an actual reduction of the tax liability of the consolidated group.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

6. Federal Income Taxes (continued)

The components of the Company’s deferred tax assets (DTAs) and deferred tax liabilities (DTLs) at December 31 are as follows:

	2019			2018			Change		
	Ordinary	Capital	Total	Ordinary	Capital	Total	Ordinary	Capital	Total
Gross deferred tax assets	\$ 8,316,191	\$ –	\$ 8,316,191	\$ 8,171,905	\$ –	\$ 8,171,905	\$ 144,286	\$ –	\$ 144,286
Statutory valuation allowance adjustments	–	–	–	–	–	–	–	–	–
Adjusted gross deferred tax assets	8,316,191	–	8,316,191	8,171,905	–	8,171,905	144,286	–	144,286
Deferred tax assets nonadmitted	–	–	–	–	–	–	–	–	–
Subtotal net admitted deferred tax asset	8,316,191	–	8,316,191	8,171,905	–	8,171,905	144,286	–	144,286
Deferred tax liabilities	1,346,920	9,502,248	10,849,168	1,750,190	5,268,989	7,019,179	(403,270)	4,233,259	3,829,989
Net admitted deferred tax asset (net deferred tax liability)	\$ 6,969,271	\$ (9,502,248)	\$ (2,532,977)	\$ 6,421,715	\$ (5,268,989)	\$ 1,152,726	\$ 547,556	\$ (4,233,259)	\$ (3,685,703)

The admission calculation components are as follows:

	2019			2018			Change		
	Ordinary	Capital	Total	Ordinary	Capital	Total	Ordinary	Capital	Total
(a) Federal income taxes paid in prior years recoverable through loss carrybacks	\$ 2,697,410	\$ –	\$ 2,697,410	\$ 3,419,212	\$ –	\$ 3,419,212	\$ (721,802)	\$ –	\$ (721,802)
(b) Adjusted gross deferred tax assets expected to be realized after application of the threshold limitation	1,951,624	–	1,951,624	632,315	–	632,315	1,319,309	–	1,319,309
1. Adjusted gross DTA expected to be realized following the balance sheet date	1,951,624	NA	1,951,624	632,315	NA	632,315	1,319,309	NA	1,319,309
2. Adjusted gross deferred tax assets allowed per limitation threshold	NA	NA	40,911,841	NA	NA	37,741,376	NA	NA	3,170,465
(c) Adjusted gross deferred tax assets offset by gross deferred tax liabilities	3,667,157	–	3,667,157	4,120,378	–	4,120,378	(453,221)	–	(453,221)
(d) Deferred tax assets admitted as the result of application of SSAP No. 101									
Total (2)(a) + 2(b) + 2(c)	\$ 8,316,191	\$ –	\$ 8,316,191	\$ 8,171,905	\$ –	\$ 8,171,905	\$ 144,286	\$ –	\$ 144,286

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

6. Federal Income Taxes (continued)

	<u>2019</u>	<u>2018</u>
(a) Ratio percentage used to determine recovery period and threshold limitation amount	101%	1,135%
(b) Amount of adjusted capital and surplus used to determine recovery period and threshold limitation in 2(b)2 above	\$ 272,608,851	\$ 251,609,174

The Company did not utilize any reinsurance tax planning or any other tax planning strategies in 2019 or 2018 that had an impact on gross and net deferred tax assets.

There are no temporary differences for which deferred tax liabilities are not recognized.

Current income taxes incurred consist of the following major components:

	<u>2019</u>	<u>2018</u>	<u>Change</u>
1. Current income tax:			
(a) Federal	\$ 165,328	\$ 1,756,696	\$ (1,591,368)
(b) Foreign	–	–	–
(c) Subtotal	165,328	1,756,696	(1,591,368)
(d) Federal income tax on net realized capital gains	306,071	401,094	(95,023)
(e) Other, including prior year adjustment	(92,479)	(87,881)	(4,598)
(f) Federal and foreign income taxes incurred	\$ 378,920	\$ 2,069,909	\$ (1,690,989)

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

6. Federal Income Taxes (continued)

The main components of deferred tax amounts are as follows:

	December 31		Change
	2019	2018	
2. Deferred tax assets:			
(a) Ordinary:			
Loss reserve discounting	\$ 3,476,010	\$ 3,453,330	\$ 22,680
Unearned premium reserves and premium deposits	1,986,458	1,667,110	319,348
Investments	488,732	450,684	38,048
Fixed assets	189,664	232,688	(43,024)
Deferred compensation and benefits accrual	175,845	206,879	(31,034)
Receivable – nonadmitted	69,601	7,134	62,467
Other	1,929,881	2,154,080	(224,199)
Subtotal gross ordinary deferred tax assets	8,316,191	8,171,905	144,286
(b) Statutory valuation allowance adjustment – ordinary	–	–	–
(c) Nonadmitted deferred tax assets – ordinary	–	–	–
(d) Admitted deferred tax assets – ordinary	8,316,191	8,171,905	144,286
(e) Capital	–	–	–
Subtotal gross capital deferred tax assets	–	–	–
(f) Statutory valuation allowance adjustment – capital	–	–	–
(g) Nonadmitted deferred tax assets – capital	–	–	–
(h) Admitted capital deferred tax assets	–	–	–
(i) Total admitted deferred tax assets	8,316,191	8,171,905	144,286
3. Deferred tax liabilities:			
(a) Ordinary:			
Depreciation	94,082	97,945	(3,863)
Tax Reconciliation Act Limited Risk Distributor	1,252,838	1,652,245	(399,407)
Subtotal ordinary deferred tax liabilities	1,346,920	1,750,190	(403,270)
(b) Capital:			
Tax effect of unrealized capital gains	9,502,248	5,268,989	4,223,259
Subtotal capital deferred tax liabilities	9,502,248	5,268,989	4,223,259
(c) Total	10,849,168	7,019,179	3,829,989
4. Net deferred tax assets	\$ (2,532,977)	\$ 1,152,726	\$ (3,685,703)

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

6. Federal Income Taxes (continued)

The change in deferred net income taxes comprises the following, exclusive of nonadmitted DTAs:

	December 31		
	2019	2018	Change
Total deferred tax assets	\$ 8,316,191	\$ 8,171,905	\$ 144,286
Total deferred tax liabilities	(10,849,168)	(7,019,179)	(3,829,989)
Net deferred tax asset	(2,532,977)	1,152,726	(3,685,703)
Net deferred tax assets/liabilities after valuation allowance	\$ (2,532,977)	\$ 1,152,726	(3,685,703)
Tax effect of unrealized gains			4,195,211
Statutory valuation allowance on unrealized gains			—
Change in net deferred income tax			<u>\$ 509,508</u>

The federal income tax expense incurred differs from the amount computed by applying the expected U.S. corporate income tax rate of 21% to income before taxes for the years ended December 31, 2019 and 2018. The significant items causing this difference were the change in dividends from affiliates, tax on capital gains, tax-exempt income, the nondeferrable portion of change in unearned premium, and the discounting of loss reserves.

On December 22, 2017, the Tax Cuts and Jobs Act was enacted, which significantly revised U.S. corporate income tax law by, among other things, reducing the corporate statutory income tax rate from 34% to 21% beginning January 1, 2018. As of December 31, 2018, the Company has completed its accounting for the effects of the Tax Cuts and Jobs Act, and there were no material adjustments to the amounts shown above during the measurement period.

The Company has no capital loss carryforwards as of December 31, 2019 or 2018.

The Company recognized alternative minimum tax credit carryforwards of \$160,770 in 2018.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

6. Federal Income Taxes (continued)

The following represents income tax expense that is available for recoupment in the event of future net losses:

	Ordinary	Capital	Total
2019	\$ 165,328	\$ 306,071	\$ 471,399
2018	1,824,916	401,095	2,226,011
2017	NA	678,823	678,823
	\$ 1,990,244	\$ 1,385,989	\$ 3,376,233

The Company has no admitted deposits under Section 6603 of the Internal Revenue Code. As of December 31, 2019, the Company is subject to federal examination in the United States from 2015 to present.

7. Commitments and Contingencies

The Company leases office facilities and certain equipment under noncancelable operating leases through 2022, with certain leases having renewal options for two five-year periods. Annual rental expense under these lease agreements was \$937,093 and \$914,987 in 2019 and 2018, respectively.

Future minimum commitments under these leases as of December 31, 2019, are as follows:

2020	\$ 822,195
2021	849,391
2022	716,028
Thereafter	—
	\$ 2,387,614

Lawsuits against the Company for matters other than insurance claims occasionally arise in the ordinary course of business. Management believes that losses to the Company resulting from such matters, if any, will not have a material adverse effect on the Company's financial condition or results of operations.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

8. Information Concerning Parent, Subsidiaries, and Affiliates

Through December 31, 2019, WPIC was a wholly owned subsidiary of the Company. Until 2004, WPIC provided medical professional liability insurance to hospitals, stop-loss insurance, and business office insurance. WPIC ceased writing nearly all business in 2004 and has reported no earned premium since 2007. WPIC was 100% reinsured by the Company for policy limits up to \$5 million. Limits above \$5 million were placed in the facultative market. The personnel of the parent company conducted the management of WPIC's affairs. On December 31, 2019, the Company sold two-thirds of WPIC common stock to COPIC Insurance Company and Michigan Professional Insurance Exchange in a transaction that was approved by the Department on December 2, 2019. Gains recognized from this transaction were \$266,666. Prior to the sale, WPIC declared extraordinary dividends of \$6,088,177 and \$605,125 on February 27, 2019 and December 31, 2019, respectively. Such amounts were paid to the Company on August 12, 2019 and March 6, 2020, respectively. The distribution above accumulated earnings in the amount of \$2,500,000 was recorded as return of paid-in capital to the Company.

PI is the primary reinsurer for its affiliate, MedChoice RRG, which writes MPL business nationally and participates as a reinsurer for independent MPL insurers and RRGs.

9. EDP Equipment and Software

EDP equipment and operating and nonoperating system software are carried at cost less accumulated depreciation. Depreciation expense for EDP equipment and operating system software is computed using the double-declining-balance method over the lesser of the estimated useful life of the related asset or three years. Depreciation expense for nonoperating system software is computed using the double-declining-balance method over the lesser of its estimated useful life or five years.

EDP equipment and operating and nonoperating system software at December 31 consist of the following:

	<u>2019</u>	<u>2018</u>
EDP equipment	\$ 998,571	\$ 1,109,816
Accumulated depreciation	(908,499)	(947,364)
Balance, net	<u>\$ 90,072</u>	<u>\$ 162,452</u>

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

9. EDP Equipment and Software (continued)

Depreciation expense related to EDP equipment and operating and nonoperating system software, including nonadmitted assets, totaled \$165,026 and \$214,793 for the years ended December 31, 2019 and 2018, respectively.

10. Employee Benefit and Deferred Compensation Plans

The Company's employees are covered by two defined contribution plans. One plan requires no employee contribution, and the Company contributes 10.0% of eligible compensation to the plan. The second plan allows employee contributions, and 100.0% of those contributions are matched by the Company up to a maximum of 6.6% of eligible compensation. Employees vest 20.0% per year in employer contributions over the first five service years and vest immediately in all employer contributions upon completion of five service years. The Company's contribution to these plans was \$1,770,528 and \$1,690,343 for 2019 and 2018, respectively.

Deferred compensation agreements have been entered into with certain members of the Board of Directors and nondirector committee members. Amounts recorded as a liability in accordance with those agreements as of December 31, 2019 and 2018, were \$251,085 and \$270,097, respectively.

11. Policyholders and Surplus, Dividend Restrictions, and Risk-Based Capital

The following table shows the cumulative increase (reduction) of unassigned funds related to the following items:

	As of December 31	
	2019	2018
Unauthorized reinsurance	\$ (101,285)	\$ (89,961)
Nonadmitted assets and other	(3,483,777)	(4,272,212)
Unrealized capital gains on investments, net of taxes	16,914,330	7,246,340

The directors of a domestic mutual insurer may from time to time apportion and pay dividends to its members only out of that part of its surplus funds that are in excess of its required minimum surplus and that represent net realized savings and net realized earnings from its business. Without the prior written consent of the Department, dividends in 2020 are limited to approximately \$5.1 million. Dividends declared and paid were \$5,002,244 and \$5,002,475 during 2019 and 2018, respectively.

Physicians Insurance A Mutual Company

Notes to Financial Statements – Statutory Basis (continued)

11. Policyholders and Surplus, Dividend Restrictions, and Risk-Based Capital (continued)

The Company is subject to risk-based capital (RBC) requirements of the NAIC, which require that certain amounts of capital be maintained. As of December 31, 2019 and 2018, the Company's RBC exceeded the required amount.

12. Subsequent Events

In March 2020, the World Health Organization declared the outbreak of a novel coronavirus (COVID-19) as a pandemic which continues to spread throughout the United States. In accordance with government directives, the Company closed its offices effective March 17, 2020. All operations have proceeded since that date on a remote basis.

Management is currently evaluating the impact of the pandemic and has concluded that while it is reasonably possible that the virus could have some effect on the Company's financial position, results of its operations, and cash flows, the specific impact is not readily determinable as of the date of these financial statements. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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